A Study of Merger, Acquisition and Bank Advisors

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ABSTRACTS - This research paper is concerned with the role of Bank Advisors in Merger & Acquisitions. Furthermore to see the need to take advice of Bank Advisors while merging or acquiring and the benefits of such advice given to them. The researchers have adopted the descriptive, comparative, analytical methods as a research methodology throughout the course of this paper and he is relying on books, articles and online databases. The bank advisors play a central role in advising the firms while merger and acquisition takes place. At many places where the situation requires the bank advisors advice the firms not to merge or acquire as the case may be. The writer has formulated the following questions and has tried to find out the answer of following questions

What is the role of Bank advisors in merger & Acquisition?
To what extent the firms may be benefited with the advice of Bank advisor?
What are those institutions which work as Bank Advisor; Investment Banks or Commercial Banks?
What are the benefit and its measurement given to the Bank Advisors?

Key words:

1 Merger
2 Acquisitions
3 Role of Bank Advisors

INTRODUCTION

The researchers, through in this research paper, are striving to show the role of bank advisors in merger and acquisition. It is assumed that the financial intermediaries are experts in information production and processing. As advisors to both targets and acquirers, financial institutions utilize their information gathering expertise to ascertain the reservation price of the merger counterparty, the potential for synergistic gains, as well as the risks of the transaction.

Commercial banks may be well positioned to offer these services if they have established lending and other customer relationships with either party to a merger. During the course of a long-term customer relationship, a commercial bank obtains private information about a firm's cash flows, financial resources, and other exposures that can be useful in estimating the future prospects of a proposed merger. Indeed, if the role of the financial advisor in a merger is to mobilize information, then commercial banks, especially those with prior lending relationships potentially have a comparative advantage over investment banks in advising their customers particularly since, until very recently, investment banks did not make commercial loans. The bankruptcy code of US prohibit the transfer of information from an investment bank subsidiary to a related commercial bank subsidiary, there are no restrictions on the reuse of information obtained in the course of a standard banking relationship (e.g., on information flows from the bank's lending department to the investment bank).

The Banks have the ability to mobilize private information about a customer, and to use this information in supplying services such as merger advice to the customer, as the certification effect. Investment banks may also be privy to private information obtained, for example, in the course of underwriting activities. However, underwriting episodes are discrete and intermittent, corresponding to the relatively short time period surrounding the issue registration, offering period, and after-market support period. In contrast, commercial bank lending and other relationships are often long standing and continuous, requiring the ongoing monitoring of the firm's activities. The selection and use of a commercial bank advisor in an M&A transaction provides a higher certification effect than that provided by traditional investment banks.

There are, however, countervailing influences to the certification effect that may limit the effectiveness of commercial banks in providing merger advisory services. This is especially so if the bank advisor is faced with one or more conflicts of interest. For example, the target firm may have financial problems known privately only to its lenders (such as the major bank lender), or an acquirer firm may be financially weak to the private knowledge of the banker, and its ability to survive and pay off its bank debt may be enhanced through the acquisition of a target with a sizable free cash flow. In these situations, the commercial bank's certification may not be credible because of the bank's self-interest in assuring the

completion of the merger. This conflict of interest effect is likely to be exacerbated in the case of hostile takeovers. For example, if a commercial bank customer (as a target) objects to an acquisition, perhaps because of entrenched managers' fear of loss of control, then the commercial bank may be either unable or unwilling to utilize fully its private information in advising a potential acquirer for fear of the loss of future commercial banking business should the merger actually fail to be completed.

Moreover, a commercial bank may be able to attract merger advisory business only on the condition that bank loans are made available to the merger counterparties, or alternatively, a bank may be more willing to advise a firm to undertake an acquisition if it believes it can earn large fees from financing the merger through its lending department. These may constitute conflicts of interest to the extent that the bank's advice is tilted by the bank's concern about the profit it earns from its lending as well as is merger advisory services.

Target firms are typically smaller and more like opaque (difficult to understand) firms than acquiring firms. Banks that advise target firms can reuse information obtained in the course of a prior banking relationship by certifying the value of the merger (e.g., whether the price the acquirer offers to pay for the target is appropriate). The target bank's private information about the target firms particularly valuable because of information asymmetries that make it difficult to certify the value of the target, and because it is the target firm that must be priced in a merger. However, this certification effect is likely to be reduced if the target bank advises the acquirer, since the target's bank may be reluctant to reveal bad information about the target to the acquirer for fear that if the deal is not completed; the target will penalize the bank with the loss of its banking business. Acquirer's abnormal returns are either negative or statistically insignificant both when the target's bank and the acquirer's bank advise the acquirer, and that the use of commercial bank advisors with prior banking relationships has no significant impact on acquirer abnormal returns.

However, if an acquiring firm has had a prior lending relationship with a commercial bank, then the acquirer is more likely to utilize that bank as its financial advisor. This is not because of an informational certification effect, but rather due to the bank's implicit (or explicit) promise of bank loans to finance the merger transaction and post-merger transition. Thus, it is the combination of merger advisory services and access to bank credit that is the focus of acquirer concerns in choosing their financial advisor. This creates a potential conflict of interest for the bank advisors. Bank advisor abnormal returns are significantly reduced when banks offer these "package deals" that combine loan commitments with merger advisory services.

THE BANK ADVISOR: It's Meaning

It has been considered that the financial intermediaries are experts in information production and processing. As advisors to both targets and acquirers, financial institutions utilize their information gathering expertise to ascertain the reservation price of the merger counterparty, the potential for synergistic gains, as well as the risks of the transaction[1].

Commercial banks may be well positioned to offer these services if they have established lending and other customer relationships with either party to a merger[2]. During the course of a long-term customer relationship, a commercial bank obtains private information about a firm's cash flows, financial resources, and other exposures that can be useful in estimating the future prospects of a proposed merger[3]. Indeed, if the role of the financial advisor in a merger is to mobilize information, then commercial banks, especially those with prior lending relationships potentially have a comparative advantage over investment banks in advising their customers particularly since, until very recently, investment banks did not make commercial loans[4].

Bank has the ability to mobilize private information about a customer, and to use this information in supplying services such as merger advice to the customer, as the certification effect. The Banks which has a good business relation with any particular firm, is able to advice those properly.

[1] Allen, L., Jagtiani, J., Peristiani, S., Saunders, A., The role of bank advisors in mergers and acquisitions. *Journal of Money, Credit, and Banking (*2004) 36.

[2] Ibid
[3] Ibid
[4] Ibid

MERGER AND ACQUISITION: Its value

The market power hypothesis stipulates that mergers enhance the competitive position of the target. Berkovitch and Narayanan (1993) find evidence of the *cooperation motive* in mergers and acquisitions[5]. Hubbard and Palia (1999) find synergistic gains to targets in the creation of internal capital markets within conglomerates created by a program of diversifying mergers and acquisitions[6].

Whereas targets must receive some expectation of gain in order to win the approval of their target shareholders for any merger, those acquirer firm managers, who are free by pressure from value maximizing shareholders, may embark on acquisitions that offer no ex ante gain to stockholders. The managerial risk diversification hypothesispostulates that acquiring firm managers undertake (value reducing) mergers in order to reduce their diversifiable human capital investment in their firm. In a European context, Cybo-Ottone and Murgia (2000) show that diversifying mergers are value reducing, whereas focusing mergers are value enhancing. In the *winner's curse* or *hubris hypothesis*, overly optimistic acquirers overbid for targets. For example, Roll (1986) shows that acquirers who overestimate the value of the target are more likely to successfully complete a merger, resulting in a decline in the acquirer's value to stockholders.

INVESTMENT BANKS Vis a Vis COMMERCIAL BANKS

The banking sector is split into two fundamental divisions: investment banking and commercial banking[7].Commercial banks manage deposit accounts, such as checking and savings accounts, for individuals and businesses. They make loans to the public using the money held on deposit. On the other hand, Investment banks differ strongly; these institutions facilitate the buying and selling of stocks, bonds and other investments, as well as helping companies to go public with initial public offerings (IPO)[8]. In other words, a commercial bank may legally take deposits for checking and savings accounts from consumers[9],an investment bank operates differently; an investment bank does not have an inventory of cash deposits to lend as a commercial bank does[10]. In essence, an investment bank acts as an intermediary, and matches sellers of stocks and bonds with buyers of stocks and bonds[11].

Kroszner and Rajan (1994), Ang and Richardson (1994), and Puri (1996), among others, find that the debt securities underwritten by commercial banks prior to Glass-Steagall's passage in 1933 were less likely to default than those underwritten by investment banks. In addition, yields tended to be lower and the credit quality higher for commercial bank under written issues than for issues underwritten by investment banks. Moreover, no significant difference was found in the performance of the equities underwritten by investment banks during the 1920s as opposed to commercial bank affiliates[12]. Indeed, Puri (1994, 1996) finds evidence of a certification role for commercial banks as they enhance their reputations by reusing private information obtained in the course of banking relationships. Although the Glass-Steagall Act did not prohibit banks from advising in mergers and acquisitions cases, the relevance of certification effects and of potential conflicts of interest, in the area of merger advisement, is the central empirical question being investigated in this paper.

THE CONCEPT OF ADVISORS IN MERGERS

The question iswhether advisors add value to a merger. Bowers and Miller (1990) examine the relationship between an acquiring firm's stock returns and the choice of investment bank to determine whether first-tier investment banks generate better deals in terms of value creation. They report that total wealth gains are larger when either the target or acquirer uses a first-tier investment bank. The results suggest the importance of the advisor's credibility (reputation) in acquisitions[13].

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[5]Supra n. 1, p. 8
[6] Ibid
[7]http://smallbusiness.chron.com/investment-bank-vs-commercial-bank-3450.html last visited on 26.11.11 at 9:50
[8] ibid
[9] http://www.vault.com/wps/portal/usa/vcm/detail/Career-Advice/Job-Search/Commercial-Banking-vs.-Investment-Banking?id=1626&filter_type=0&filter_id=0 last visited on 26.11.11 at 1.00 am
[10] ibid
[11] Ibid
[12] Supra note 1, p. 7
[13]http://www.sciencedirect.com/science/article/pii/S1047831005000076 last visited on 27.11.2011, at 4:20 pm

Hunter and Walker (1990) find that merger gains relate positively to investment banking fees and other proxies for investment banker effort. However, McLaughlin (1990, 1992) reports that some incentive features of investment banking contracts can create conflicts of interest between an investment bank and its clients, suggesting the importance of a potential for a conflict of interest between advisors and clients in mergers and acquisitions[14].

Servaes and Zenner (1996) compare acquisitions that were completed in-house versus those that use investment bank advisors. They find that an investment bank is used in more complex transactions with asymmetric information, documenting the importance of the information collection process in mergers and acquisitions.

Building on the theoretical model in James (1992), Saunders and Srinivasan (2001) find that merger advisory fees include a relationship premium that is consistent with the existence of switching costs borne by acquirers when they hire new advisors with whom they had no prior relationship. If merger fees are set competitively, an explanation for this relationship premium isa certification effect, whereby rents are paid to banks with superior information obtained in the course of a prior relationship. Saunders and Srinivasan (2001) also find that top tier advisors charge higher fees than lower tier investment banks, and that acquirers pay a relationship premium in merger fees that is highest for top tier advisors. Although Rau (2000) finds no impact of advisors on acquirer abnormal returns, he shows a positive relationship between investment bank market share and fees and deal completion rates. That is, top-tier investment bank advisors create value by increasing the likelihood that the deal will be completed.

MAIN FEATURES OF TARGETS &ACQUIRERS

There is difference between deals advised by top tier and mid-tier investment banks and those advised by commercial banks. The mid- tierindicates those deals using only mid-tier investment bank advisors during the time periods when these firms were independent. There were no commercial bank advisors at all in the investment bank advisor control groups[15].

Several control factors are incorporated into the model to capture the impact on abnormal returns resulting from characteristics of the target or the acquirer. These control factors are as follows:

1Control factors

The announcement returns to bidding firms who make cash offers are higher than when stock offers are made, since a bidder with private information about the value of its own assets offers stock when its shares are overvalued by target shareholders. Recognizing this adverse selection effect, target shareholders reduce their estimate of a bidder's value[16]. Thus, without some other benefit to target stockholders in receiving stock rather than cash as a means of payment, a "lemons problem" arises for stock offers. Stulz, Walking, and Song (1990) find that the relationship between a target's abnormal return and the target firm's ownership structure depends on the relative power of the bidder to successfully complete the acquisition without competition from other bidders (i.e., the stronger the bidder -in terms of either lower target management's ownership stake, larger bidder ownership stake, or fewer bidders, the lower the target's abnormal returns).

Cotter and Zenner (1994) document that abnormal returns are lower for hostile compared to friendly mergers, controlling for size, ownership factors, and other characteristics of the offer (e.g., whether there are multiple bidders and whether the target has a golden parachute). Targets may also be valuable because of their high profitability and growth rate.

2 Target abnormal returns with investment banks

Abnormal target return is higher when there is at least one top tier investment bank advisor as compared to a commercial bank advisor, although the difference is statistically insignificant. Without controlling for banking relationships, target abnormal returns are significantly increased when the deal is cash financed and when the target firm's growth rate declines.

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[14] http://docs.google.com/viewer?a=v&q=cache:D2jh3brJ7jwJ:citeseerx.ist.psu.edu/viewdoc last visited on 27.11.2011, at 4:20 pm

[15] Supra note no. 1, p. 11

[16] Ibid

3 Target abnormal returns with commercial banks

Priorbanking relationships affect the target abnormal returns. The targets get benefited from hiring their own banks as advisors in mergers and acquisitions. Thus, the nature of the prior relationship between the bank advisor and its merger counterparty is important in determining the size of a target's abnormal returns. Specifically, the target significantly increases its abnormal returns when it chooses to receive merger advice from its own bank, as compared to the base case of deals in which all advisors are either top tier investment banks or commercial banks with no prior relationships to either merger counterparty. The cash financed mergers have significantly higher target abnormal returns. The target firm growth rate significantly reduce target abnormal returns, consistent with the view that the expected cost of integrating a relatively larger, faster growing target into the merged firm reduces that target's abnormal returns.

4 Acquirer abnormal returns with investment bank

There is no difference, on average, between acquirer abnormal returns for deals advised by at least one commercial bank as compared to deals without commercial bank advisors and with at least one top tier investment bank advisor.

5 Acquirer abnormal returns with commercial banks

All banking relationship variables are statistically insignificant in all regressions. There is no gain to the acquirer from a specific relationship between the merger counterparties and the commercial bank advisors. The acquirers, as well as targets, benefit from avoidance of the "lemons problem" by the use of cash in financing mergers[17].

APPOINTMENT OF BANK ADVISORS

The identity of an advisor may be endogenously determined by either deal specific or company-specific characteristics. The importance of a bank advisor in explaining a target's returns may be attributable to a firm's (either target or acquirer) characteristics, such as leverage or size, rather than the identity of advisors themselves. Hence, target or acquirer should test for a potential selectivity bias by examining the importance of firm-specific characteristics in predicting advisor choice.

Deals using top tier investment bank advisors were less likely to use cash financing and had larger acquirers than deals using commercial bank advisors. This suggests that deal-related information production by commercial banks is more valuable to smaller acquirers that pay cash for targets.

BENEFIT BY WAY OF RETURN OF BANK ADVISORS

Any synergistic gains generated by a commercial bank's advice to a merger counterparty should be reflected in the advisor's returns, as well as in the returns to the target or the acquirer, since such gains are likely to add to the reputational value of the bank as an M&A advisor. Consequently, we also examine the impact of merger announcements on advisors' returns. Unlike targets and acquirers, advisors participate in deals as a normal part of their business, and, therefore, the distinction between "normal" and "abnormal" returns is not meaningful. A commercial bank experiences positive returns when it is hired as the target's advisor. Information about targets, obtained in the course of a prior credit/lending relationship, can be "reused" by banks to generate positive returns from merger advisement

CONCLUSION

To sum up if financial advisor in a merger is to mobilize information, then commercial banks potentially have a comparative advantage in advising their banking customers as compared to non-bank advisors (i.e., traditional investment banks). This is known as the bank certification effect. All else being equal, access to information generated in the course of a lending/credit relationship would enhance the merger counterparty's abnormal return upon announcement of a merger. However, there is a countervailing influence to the certification effect in that the commercial bank may be faced with a conflict of interest that diminishes the value of any such certification effect. In particular, the bank may be unable to credibly relay information about the merger counterparty's value if there is concern that the bank is using the merger as a way to reduce its own lending exposure to the client. Whichever effect predominates determines whether using commercial bank advisors increases or decreases acquirer's and/or target's abnormal returns in mergers and acquisitions. This process effect takes the form of increased abnormal returns to targets whenever their merger advisor is their own bank (with whom the target has had a prior banking relationship). Moreover, bank advisors themselves also appear to

[17] Supra note no. 1

benefit from certification gains to merger counterparties, particularly when they use their information generation and certification functions to advise targets. Consequently, the market appears to value an informed bank certification of small, relatively information ally-opaque target firms.

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